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Managing Editor

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The matter contained in this publication, unless otherwise stated, will not be binding upon the Society; and it should be understood that any opinions expressed in articles published herein are the opinions of the authors of the articles, respectively, and are not promulgated by the Society.

STATE SOCIETY ACTIVITIES

Calendar of Events

May 4—Regular Meeting of the Board of Directors.

May 8—7:45 P. M.—Annual Meeting of the Society. Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York. Speaker: Frank C. Moore, Comptroller of the State of New York.

June 22—Regular Meeting of the Board of Directors.

September 7-8—Eleventh Annual Regional Chapter Conference. Location: The Sagamore Hotel, Bolton Landing, Lake George, New York.

October 9—Regular Meeting of the Society. Location: Waldorf-Astoria Hotel, New York.

Membership for Committees

In order to facilitate the appointment of committees for the year 1944-45, President-elect Horne requests that members desirous of serving on technical committees of the Society (a list of which appears in the Year Book) advise the Society's office concerning those on which they feel qualified to serve. Committees will be selected during the summer and will take effect on October 1, 1944.

Members expressing a desire to serve on committees and accepting committee appointments should realize that acceptance conveys a willingness to assume the responsibilities of a member of the committee, and to attend meetings and work on the activities of the committee.

Election of Officers

On May 8, 1944, the election of officers and directors of the Society for the forthcoming year was held at the Waldorf-Astoria Hotel. The Nominating Committee submitted the names of the following officers and directors for the ensuing year, who were subsequently elected to office. They will assume office on October 1, 1944.

OFFICERS

HENRY A. HORNE.....*President*
WM. R. DONALDSON..*First Vice-Pres.*
PRIOR SINCLAIR...*Second Vice-Pres.*
CHARLES H. TOWNS.....*Secretary*
HARRY E. VANBENSCHOTEN..*Treas.*

DIRECTORS
(For a Period of Three Years)

THOMAS F. CONROY
HENRY HOMES
ROY B. KESTER
SAUL LEVY
HENRY E. MENDES

DIRECTOR
(For a Period of One Year)

WILLIAM EYRE

Mr. Horne, in accepting his election as President of the Society, spoke as follows:

This is a great responsibility that you have entrusted to me. The administration of the affairs of our Society in this time of war calls for an amount of wisdom and patience that may not be fully available when most needed. I shall take up the burden with grave respect but with serene confidence that my fellow officers and directors, so wisely selected by you, will join with me in team-work that will bring about a successful administration.

I thank you for this proof of your friendship. Some of us have been friends for all the thirty-two years during which it has been my privilege to be a member of this great professional society. Others have been friends for shorter periods of time. But—we have been friends—and the foremost thought in my mind at the present time is to thank you for that friendship.

This is a time of great events. It

may well be that, as we sit here tonight, the greatest military adventure of all time is being launched. Our men will be in it and some of them will be lost. Our men—members of this society—were in the assault at Casablanca and in the landings on Sicily. That is what we expect of our men because they are men—in every sense of the word. Our men are Americans—patriotic, intelligent and resourceful. The young men are in uniform, following the flag on the land, at sea, and in the air. Older men are giving their services to the nation in the places where best they can use the skills, competencies and abilities that have become theirs through years of professional practice.

The independent certified public accountant is now held in high esteem. A half-century of experience has made the American business world aware of the two outstanding characteristics of professional accountancy: first, integrity of character and, secondly, competence in the performance of technical tasks.

In the months and years that lie ahead we shall need all that we have of integrity of character and of technical skill. As we grope forward into the future we can discern the shape of some of the tasks of accountancy. First is the task of accounting for the termination of war contracts. All Americans eagerly look for the Day of Victory. Terminations are but a thin stream now, but victory will bring with it a flood of cancellations and terminations. Business and the Government will make demands on us in respect of the preparation of settlement claims that will call for all our intelligence and for all the strength of character that we should have.

Secondly, I think of the crying need for the simplification of the incredible hodge-podge into which our taxing systems (both Federal and State) have fallen. For years our Society has been advocating a revision of taxation. Now is the time for action.

Thirdly, our post-war business structure will need many adjustments that will be brought about by mergers, consolidations, refinancings, and some liquidations. These are matters wherein the professional accountants' interpretation of financial history will be of prime importance.

In these matters, as in all fields of our activity as independent accountants, the high ethical standards that have characterized professional accountancy throughout its entire history must be maintained.

We are not special pleaders. We tell the truth.

April Meeting

The papers presented at the April 10, 1944, meeting of the Society on the subject of "Termination of Government Contracts in War and Peace" are printed in this issue with the exception of the paper presented by Charles J. Dunleavy, Chief Auditor of the New York Ordnance District.

Due to the fact that termination procedures outlined by Mr. Dunleavy have changed since his presentation he requested that the article not be published.

E. Harold C. Clark

E. Harold C. Clark, a member of the Society since September 1941, passed away on April 12, 1944.

Berthold J. Joerger

Berthold J. Joerger, a member of the Society since November 1936, passed away on April 11, 1944.

Arthur Lehmann

Arthur Lehmann, a member of the Society since March 1943, passed away on April 14, 1944.

The Society has suffered a great loss in the passing of these valued and esteemed members.

The Accounting Aspects of War Contract Termination

By COMMANDER J. HAROLD STEWART, S.C., U.S.N.R.

THERE has been so much said and written about the termination of Government war contracts that it is difficult to distinguish the authoritative matter from that which is speculative. I should like to make it clear at the outset that what I may say represents my personal opinion with respect to the matters discussed and should not be construed to be an official pronouncement on behalf of the Navy Department.

For several years now, those of you on the production front have been struggling with the vast problems of converting a peacetime industrial set-up to the requirements of total war. The problems of acquiring machine tools, facilities, critical materials and manpower have had to be met. In meeting these problems, a substantial part of the burden has fallen upon the accounting profession. The war is not yet won, but the established success with which production problems have been met augurs well for the ability of industry to meet the equally perplexing problems of war contract termination and post-war readjustment. Substantial progress has been made in preparing for the reconversion of industry in the light of the tremendous importance which such reconversion will have in shaping the future of our nation.

As you know, Mr. Bernard M. Baruch and Mr. John M. Hancock, acting under instructions from the Director of the Office of War Mobilization, have completed an exhaustive study which resulted in a report on War and Post-War Adjustment Policies, dated February 15, 1944. Most of you are undoubtedly familiar with the essence of that report. Likewise, several Congressional committees have directed their attention to the problem, notably the Senate Military Affairs Committee, headed by Senator Murray, and the Special Committee on Post-War Economic Policy and Planning, headed by Senator George. In substance their conclusions as to procedures are analagous, the principal difference of concept being as to who should be responsible for directing the procedures.

The essence of successful contract termination is speed. We can lose billions of dollars through delay in getting into peacetime production when the war is over. Each week of delay in consummating a termination results in additional expense to the Government, particularly due to the loss of productive activity of industry. The consequence of delay will be such that the country cannot afford the existence of any impediment to speedy contract settlement.

A negotiated settlement, it is felt, affords the best avenue to the attainment of a speedy result. The propriety of negotiating a settlement between a Government contracting officer and a contractor has been affirmed by the Supreme Court of the United States, and it is the usual method employed in the settlement of commercial transactions. If negotiation is not possible, settlement under a prescribed formula would appear likewise to be impossible. As you know, there are many matters of accounting principle which cannot be defined precisely in a formula and in respect of which there can be honest differences of opinion. These differences can be resolved only by

Presented at the April 10, 1944 meeting of the New York State Society of Certified Public Accountants.

negotiation or judicial interpretation. Both from the standpoint of the Government and industry, it is preferable that there be reasonable justice speedily obtained rather than meticulous justice slowly arrived at.

The principal sufferers from delay will be the small and moderate-sized contractors. The larger industries of the country can presumably bear the load better. In many cases they have their national reputations and established credit status and a diversity of operations which reduces the shock. The smaller contractor with credit problems and a much more serious labor problem due to his lack of diversity must obtain speedy relief from the stagnation which can follow contract termination. Labor can likewise suffer severely from delay. If termination funds are not forthcoming seasonably, payrolls cannot be met and shutdowns and lay-offs will be inevitable. Consequently, every effort should be bent toward speedily negotiated settlements, subordinating as far as possible the accounting features.

There has been a fear on the part of some that the accounting aspects of war contract termination may be over-emphasized. I believe that any accountant concerned with the problem will and should use every device to reduce the accounting burdens incident to termination to a minimum. It is, however, inescapable that in thinking of their claims against the Government, the first thought of contractors is that they be reimbursed for their financial outlay which can be measured only in accounting terms. In effecting a negotiated settlement, the role of the accountant is advisory rather than determinative. However, accounting skill of the highest order is required to furnish competent advice without unnecessarily detailed procedures.

Several constructive steps have been taken in the direction of clarifying the accounting philosophy which will govern termination settlements.

As you know, the Baruch Committee, with the aid of the war agencies and industry, developed a uniform termination article for fixed-price supply contracts. Although this article is not yet embodied generally in war contracts and subcontracts, the Statement of Principles for Determination of Costs, which is incorporated in the article by reference, indicates the cost concept which will be applied by the procurement agencies in reviewing the financial representations of war contractors.

The genesis of this statement may be of some interest to you. It is the result of the work of a subcommittee composed of representatives of the several procurement agencies under the direction of the Joint Contract Termination Board. In preparing the statement, the committee had the advice and assistance of outstanding industrial accountants, public accountants and representatives of industry. Undoubtedly you have noticed that the cost philosophy applied to the termination of a fixed-price supply contract differs from that applied in determining costs under Government cost-plus-fixed-fee contracts. The reasons for this are, of course, apparent. The fixed-price contractor assumes risks which the cost-plus-fixed-fee contractor does not and, in consequence, is entitled to greater latitude in the matter of cost inclusions in his fixed-price.

It should be noted particularly that the Statement of Principles indicates that the costs contemplated are those sanctioned by *recognized commercial accounting practices* and are intended to include those direct and indirect manufacturing, selling and distribution, administration, and other costs incurred which are reasonably necessary for the performance of the contract, and are properly allocable or apportionable under such practices to the contract. Gen-

erally speaking, in considering the contractor's costs, there will be included those elements of cost which were included in his fixed price. The Statement of Cost Principles includes specific comments on certain costs because of their particular significance, these being common inventory, common claims of subcontractors, depreciation, experimental and research expense, engineering and development, special tooling, loss on facilities, special leases, advertising, interest, settlement expenses, protection and disposition of property, and high initial costs. These were mentioned specifically because many questions had been raised with respect to the extent of their inclusion and there appeared to be a general demand for information as to their treatment.

At this point, I think we may profitably review the treatment of some of these items.

Inventory — It should be recognized that there are questions and factors encountered in the termination of a contract which would not have been met in its fulfillment. Ordinarily, the only termination costs which must be ascertained are those related to the inventory of raw materials at the effective date of termination and to work then in progress. It is unnecessary to consider costs of completed articles because with respect to them the contract unit price is controlling. Inventory costs are determined on the basis of the method consistently used by the contractor if that method meets the test of generally accepted accounting principles. The inventory quantities cannot exceed the quantitative requirements of the contract to be completed. Even then, quantities acquire through unreasonable advance buying or in violation of legal restrictions on acquired inventory may be excluded. Where the character of the inventory is such that it is common to the work performed under the terminated contract and to other work of the contractor, a fair allocation of such items of inventory to both classes of work must be made. This allocation should usually be made in conjunction with the allocation of claims of subcontractors which are common to the contract and to other work of the contractor. The several categories of inventory, that is, finished goods, work in process, and raw materials, will ordinarily be determined as they exist at the time of termination. Undoubtedly there will be cases in which the distinction between classes of inventory will be difficult and it is intended that the accounting requirements be administered reasonably. For example, there may be cases in which manufactured parts or subassemblies may be identical with purchased parts, and the requirement of reporting them separately must be waived. The cost of work in process includes the usual elements of material, labor and overhead. Overhead allocable to other work of the contractor and costs treated as direct charges to the termination settlement should be excluded in determining overhead applicable to work in process. The proper determination of overhead, I think you will agree, is the area in which the greatest differences of opinion between the contractor and the Government will arise.

Depreciation — Depreciation may be included as an element of cost at appropriate rates on buildings, machinery and equipment, and other facilities, including such amounts for obsolescence due to progress in the arts and such other factors as are ordinarily given consideration in determining depreciation rates. Depreciation as such shall not include the loss of useful value of facilities acquired particularly for a contract, which loss results from the termination. Such a loss will receive consideration in another manner as I shall in-

dicate later. Appropriate rates are not necessarily the rates claimed for federal income tax purposes and amortization of facilities covered by certificates of necessity will not be recognized as an element of cost to the extent that such amortization exceeds the allowable depreciation had assets not been covered by certificates of necessity.

Experimental and Research Expense—It is provided that general experimental and research expense to the extent consistent with an established prewar program or to the extent related to war purposes may be included in the contractor's claim. It is not intended that experimental and research expense related particularly to the development of post-war products shall be allowed. In most industries the segregation of the expenditure for research and development is most difficult. In these cases where it has been a practice of long standing to conduct an experimental program, segregation is not particularly important, as current periods are obtaining the benefit of expenditures in prior periods, and attention need be directed only to the elimination of any unusual expenditure of this type.

Loss of Facilities—In the absence of special contractual provisions, loss on facilities will be subjected to particular scrutiny as it has been an established procurement policy not to include payment for facilities in contract prices without a special contract provision.

Special Leases — The Provision which allows the inclusion of losses with respect to the cancellation or disposal of special leases must be administered carefully from the Government's standpoint. It should be noted that only reasonable lease provisions will be recognized and it must be shown clearly that the lease was related to the performance of the contract under consideration and does not represent an ordinary business risk.

Advertising—It is provided that advertising expense shall be allowed to the extent consistent with the pre-war program or to the extent reasonable under the circumstances. Advertising will probably be a controversial item. As you know, except to a very limited degree, it has never been recognized as an element of cost of performing Government cost-plus-fixed-fee contracts. However, institutional advertising has had the blessing of the War Production Board and contractors have proceeded to make expenditures consonant with an expressed Government policy. It has been recognized that war producers are entitled to advertise to keep their names before the consuming public and the cost of such advertising has been included in the fixed prices which would have been realized had war contracts been completed.

Limitation of Certain Costs—The items of experimental and research expense, engineering, development and special tooling, loss on facilities, special leases, and advertising cannot in the aggregate exceed the amount which would have been available from the contract price to cover these items if the contract had been completed, after considering all other costs which would have been required to complete it. In other words, these costs are available to the contractor to the extent of the profit which he would have realized upon completion of the contract. As you can see, the administration of this feature will present certain difficulties as it will be necessary in some cases to estimate the potential profit.

The other items particularly mentioned in the Statement of Cost Principles appear to be self-explanatory. However, under cost exclusions it should be noted particularly that costs which, as evidenced by ac-

counting statements submitted in re-negotiation under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, as amended, were charged off during a period covered by a previous re-negotiation, may not be subsequently included in the termination settlement if a refund was made for such period, or to the extent that such charging off is shown to have avoided such refund. It will be noted that this barrier prevents the application of the so-called sequential cost theory. I shall not dilate further upon the cost treatment to be accorded particular items, as I am sure that the question period will develop the consideration of those other items in which you are particularly interested.

In order that there may be uniformity in the application of termination accounting principles by the several services, there is at present a subcommittee under the Joint Contract Termination Board charged with the responsibility of interpreting these principles. This committee is composed of experienced accountants who are familiar with the problems of industry and in its deliberations it is availing itself of the advice and counsel of outstanding industrial accountants, public accountants and businessmen. It is engaged at present in preparing for general distribution an elaboration of the Statement of Principles for Determination of Costs upon the Termination of Fixed-Price Supply Contracts. Standard forms for use by all procuring agencies are being developed by another sub-committee and should be available in the near future. If some of the pending legislation on property disposal is enacted the forms to be used for reporting inventories will have to be extensive.

The accounting burdens of contract termination, even though reduced to a minimum, will severely tax the facilities of governmental, industrial, and public accountants. The present governmental staffs must be augmented and the industrial and public accounting organizations are likewise under-staffed as a result of the demands of the armed forces. With additional personnel extremely limited, it is necessary to readjust the forces now available if the problem is to be met seasonably. From the standpoint of the governmental agencies, it is necessary that the more experienced accountants now in their ranks be released in many cases from their present assignments and replaced by accountants of less experienced caliber, relying upon closer supervision of them to compensate for their lack of experience.

The greatest accounting load incident to contract termination will fall upon industry and it is essential that contractors put their houses in order now so that they may discharge their responsibilities later. The larger industrial concerns can profitably set up termination units for the purpose of processing uniformly and expeditiously all claims which they may have either as prime or subcontractors. Such a unit should be staffed by experienced personnel. It is essential that those in charge of contract termination be high type executives whose impartial approach to the problem will inspire confidence on the part of the Government representatives with whom they must deal. In a large organization it is essential that termination procedures be defined and instructions be issued to both the operating and accounting personnel. It will also be necessary in many cases that the prime contractor assist subcontractors who are inadequately equipped to prepare settlement proposals. It is the duty of the prime contractor to approve of such settlements as he may make with his subcontractors. Each contractor should re-examine his accounting procedures

to make sure that they meet the test of accepted commercial accounting practice, and to the extent that they do not, appropriate adjustment should be made. For example, the extent and adequacy of inventory controls should be determined as it is extremely important that the contractor know promptly which materials are applicable to the terminated contract and where they are located. Another matter which is sometimes neglected is the maintenance of adequate commitment records. It is essential that the commitment position of a contractor with respect to its subcontractors be readily ascertainable. The failure to have this information available may result in loss to the prime contractor through failure to act seasonably in terminating subcontracts. Another field which I believe may well be explored is that of pre-determination of the cut-off point which can best be utilized in halting the several stages of manufacture. As a result of such study it may be possible in advance to arrange with the contracting agency that contracts be terminated on a progressive basis rather than simultaneously. For example, in the textile field there are certain points of process at which materials acquire characteristics which enhance their value, whereas during certain intermediate stages the value of such materials is sometimes decreased. For example, yarn, grey cloth and finished cloth can usually be disposed of advantageously as such, whereas cotton in the carding and roving stages may be worth less than raw cotton. It will be necessary that an additional campaign be carried on for the purpose of educating both the contracting agency and the contractor.

Vertical vs. Horizontal Settlements—Up to the present, contracts have been settled vertically. That is to say, the procurement agency settles with the prime contractor and he in turn settles with his subcontractor and so on down the chain. You have undoubtedly heard much talk of overall company settlements and direct company settlements. These terms have been used loosely and I think it well for purposes of our present consideration to clarify them An overall company settlement, as I visualize it, is a settlement with the company, with respect to its entire war business after segregating therefrom all its other operations. Such a settlement, by its nature, can have only limited application and its utility is confined to the day when there might be complete cancellation of a company's contracts. During the progress of the war and even after its termination, it is probable that cancellations will be effected on a staggered basis. Under these circumstances some other device than overall settlements must be used. Consideration is being given to the possibility of merged claims of a particular company. That is, to the fullest extent possible the claims of a particular contractor may be accumulated and resolved into a single settlement. The services are at present engaged in exploratory work to determine the extent to which these devices may be used. As a step in that direction, the War and Navy Departments have installed in the plants of certain war contractors termination specialists consisting of accounting and technical personnel. The plants selected for this experiment are those which have complicated termination problems and in which the contractors are both prime and subcontractors under a large number of contracts. It is hoped that by familiarizing themselves with the accounting and property features of a particular contractor, the processing of claims can be expedited by the assigned specialists. It seems to me that it is entirely possible for the services to satisfy themselves as to the sound-

ness of the accounting principles applied by the contractor in computing his termination claims well in advance of wholesale cancellation. Having become familiar with and satisfied with the contractor's method of processing claims, it should be possible to resolve the Government's examination of them to a testing and sampling basis. In this manner, the most efficient use can be made of the limited personnel available. This mechanism should also relieve subcontractors of the necessity of satisfying a large number of prime contractors as to the propriety of subcontract claims.

Consideration is also being given to the desirability of having the Government deal directly with subcontractors. That is, make so-called horizontal settlements. The feasibility of so doing is being explored and provisions permitting this procedure are included in the principal bills now before Congress.

The Baruch report indicated "currently the normal movement is for cancellations to go down from the prime at the top through the tiers below; for claims to be sent up; than for payments to come back down again. If many tiers of producers are involved, the process is likely to be slow at best with risks of serious stoppages in the flow". There have been delays in settling such cancellations as have already occurred and it is feared that with the increased number to be disposed of, delays will be further accentuated. There are those who believe that vertical settlements represent the only possible means of handling the problem. There are others who feel just as strongly about direct settlements with all, be they prime or subcontractors. It may well be that a combination of the two methods will have to be availed of. In my opinion, there is not sufficient accounting personnel to review in advance all vertical contract settlements and it is questionable whether this should be attempted. It is my own personal opinion that certain companies, due to their size and number of claims, are susceptible of review by contract specialists on a company basis, and having extended this treatment as far as the limits of personnel will allow, all other contractors might be paid on the basis of certified reports similar to tax returns. The form and content of such reports would, in that event, have to be indicated precisely with severe penalties for fraud attached, and a substantial interest charge applied to any overcharge by a contractor. The police power of the fraud penalty and high interest rate would, in my opinion, be far more valuable in preventing the filing of improper claims than the expenditure of auditing manpower in pre-audits. I know there are those who disagree completely with this approach, but it is still being explored and may yet be resorted to if the mechanics of vertical settlement become further impaired to the point that contractors are unduly delayed in obtaining settlements.

It would be possible under such an arrangement to have a post-audit similar to that which is now made of federal tax returns. While on the subject of post-audit or review, we might consider the province of the Comptroller General in contract termination. The Baruch Committee and the Murray-George bills both take the position that the Comptroller General's function is to review settlements only from the standpoint of fraud or misrepresentation. The Baruch Committee report indicated that they had weighed most carefully the suggestion that the Comptroller General be permitted to make an independent audit of every settlement and that no payment be final until approved by him. With the purpose of this suggestion—to protect the public's interest—the report agreed entirely, but said that "It is no real

protection of the public's interest to describe as a safeguard something which is administratively impractical or which would quibble the nation into a panic. By their very nature, the settlements of terminated war contracts must rest in large part on judgments of values, matters on which competent men could honestly differ. It is a field where auditing procedures can be only a limited tool".

In connection with the proposal that the Comptroller General should audit termination settlements, it should be borne in mind that the procurement agencies themselves are doing a policing job. For example, during the fiscal year ending June 30, 1943, the Cost Inspection Service of the Navy Department disallowed approximately 49 million dollars in claimed costs with respect to disbursements aggregating approximately 4 billion, 2 hundred million dollars. The bulk of the exceptions taken by the General Accounting Office so far reported represent overhead items and pertain particularly to capital stock tax, employees' vacation pay, contributions to local charities, etc. It should be borne in mind that the Baruch Statement of Cost Principles contemplated the reimbursement of fixed-price contractors for those costs which are sanctioned by recognized commercial accounting practices. In order that such reimbursement may be effected, it is essential that the judge of their propriety be thoroughly familiar with generally recognized commercial accounting practices.

I think we are all concerned with obtaining the same result, that is, that the wheels of industry may be kept turning and released for post-war production with the greatest possible speed. As Mr. Baruch has well said, "There is no need for a post-war depression. Handled with competence, our adjustment, after the war is won, should be an adventure in prosperity". In order that the adjustment may be competently handled, everyone concerned, the agencies of the Government, the contractors, and professional advisers must meet their responsibilities with seriousness, tolerance and a singleness of purpose to get the job done. You, in particular, as certified public accountants, can, I believe, be depended upon to discharge a responsibility in a manner which will reflect credit upon your profession. Here is a challenge to free enterprise to demonstrate that it can meet those responsibilities which always accompany freedom.

Termination of Government Contracts From the Viewpoint of Industry and the Certified Public Accountant

By GEORGE D. BAILEY, C.P.A.

THE problem of war contract termination is so broad and its individual points are so many and so varied that it is always difficult to make a selection of a particular phase of the problem which can be covered within the time limits of any single talk. Perhaps it is fortunate that the background of the problem has been discussed at great length during recent months and that those who are interested in the subject have had the benefit of many articles and particularly have for their information the Baruch-Hancock Report on War and Postwar Adjustments Policies. My talk today will deal with some of the accounting aspects, and I shall try to refrain from dealing with many interesting things such as conversion costs, severance wages, and similar cushions to soften the shock of change, which appear to be matters of broad public policy not particularly related to the amount of the individual claims. Before I do start on the accounting phases, I want to point out that the settlement of termination claims involves a great many other things than accounting and auditing.

Perhaps the most difficult of all is the decision that has to be made with respect to materials on hand both unworked and partly fabricated, as well as those sufficiently completed to serve as a commercial article. Manufacturing plants in many cases must be cleared of materials and machines before those plants can be put back to peacetime production. There are in many cases decisions that must be made as to special machinery and equipment which were rendered useless by the termination of contracts and which require the attention of trained production and engineering termination personnel. Inventories must be listed and checked and disposed of as the claim is being prepared. Advance planning must be done on many things which will involve agreement between the contractors and the Government. Decisions must be made as to delegations of authority for dealing with subcontractors as to material disposal, as to cancellation of leases, and as to expenses of termination. Decisions must be made in advance as to overall settlements or the grouping of contracts or the selection of the particular procurement agency which will conduct the major investigations. These matters are largely administrative and involve an intimate knowledge of the contractor's problems, his plants, his reliability, and his organization, and some of the problems in addition require inspection of physical assets. Thus, if termination settlements were to be made on the basis of a formula and in accordance with strict rules as to each item, accounting for the items subject to exact determination rather than based on judgment would still be only one part of the termination settlement process. Even more is this true when settlements are to be made on the basis of negotiation between the

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parties where it is to be presumed that points not susceptible of exact determination will all be weighed together for an aggregate fair total.

The negotiated settlement, on its face and in fact, is an agreement between the contractor and the Government as to the proper amount of the claim. It may or may not be supported or supportable by a calculated schedule of the exact amount. It is a mistake, however, to think that negotiated settlement has an arbitrary, whimsical determination whereby a careless contracting officer and a dishonest or unscrupulous contractor can casually waste the Government's money. Termination settlements are now being made every day on a negotiated basis. The procedure under which they are being made are well-defined, regulations are being refined, personnel is being trained, and organizations are being set up in the various procurement districts. It is beginning to be possible to appraise the effectiveness of the procedures from the standpoint of protection to the Government and fair and prompt settlement to the contractor. This hasn't been true, up to date. A study of the procedure as laid down by the procurement services and examination of actual procedures as being carried out in practice shows clearly how far away is the final negotiated settlement from that which some people apparently visualize as an unsupported, uncontrolled agreement between two men in a smoke-filled room.

I, myself, have just had an opportunity to make an appraisal of the termination procedures in one of the procurement agencies. I have been a member of a small civilian advisory board of the Detroit Ordnance District which has worked from time to time with Brigadier General Quinton, the District Chief. Our Board was recently asked by General Quinton to review with him the procedure followed and the organization set up for termination settlements in the Detroit district. We followed the records of an actual case from beginning to end, from the decision to terminate to the final agreement between the contracting officer and contractor. We saw the workings of a large staff of specialists, each dealing with various phases of the problem and reporting to the termination board. We saw evidences of the deliberation of that board of from four to ten members in reaching a decision. We saw that those problems which needed decision in the early days after termination were being considered from time to time even prior to the filing of the formal claim, and how matters involving judgment were being considered by numerous people. We saw the report of a Government auditor who spent in this particular case 14 days in auditing the cost factors of the claim by selective audit procedures. We saw how the claim of one subcontractor for an important amount had been investigated by a Government office in another territory, and how a claim from another subcontractor in a small amount had been passed on the basis of general knowledge rather than field investigation which obviously would not have been warranted. It was quite clear to our advisory group that negotiated settlements were settlements made by a group of people who had been making decisions on various phases of the claim at various times preceding the final settlement and who were working within a framework of sound administrative procedures. This, in very brief, was a sample of a negotiated settlement, and showed how the negotiated settlement involves many points of judgment and provides—or can provide—adequate evidence of care, of treatment within the authorized procedures, and group rather than individual decisions. It may well be that these procedures represented the

higher level of Government performance; but it seemed to me to represent a level of reasonably attainable performance for all the services.

I have gone into this in some detail because it seems to me it is important to know just how the negotiated settlement is intended to work in actual practice and what kind of care and attention is given to settlements under that method, because there still is a demand in some quarters that the Comptroller General of the United States be required to check and approve all termination settlements before they become final. The great majority of people who have investigated the consequences of such participation by the Comptroller General have come to the conclusion that such a procedure would be exceedingly dangerous to the prompt conversion of industry from war to peace. The Baruch report condemns it in positive terms. The point apparently is not settled, as evidenced by the report of the House Committee on Military Affairs and the provisions of the bill referred to as the May Bill, recommended out of that Committee, for the consideration of the House. The American Institute of Accountants has taken an official position on this point and has made representations to the Congress in favor of limiting the participation of the Comptroller General to reviews for legality and fraud. It seems appropriate at this meeting to look again at the propriety of such a decision.

As independent public accountants, I do not think we need to prove that we are believers in adequate safeguards over Government expenditures, nor do we need to prove that we believe in sound auditing procedures. We would, I am sure, be very much in favor of any participation in termination procedures by the Comptroller General which would help to assure proper handling of Government funds without interfering with prompt settlement of termination claims or a participation which would not be merely adding one audit on top of another. We would equally object, I am sure, to any auditor substituting his judgment for that of the administrative officers acting with care and in good faith.

It is my opinion that the proposals of the May Bill do just that—substitute the judgment of the General Accounting Office for that of the settlement officers in the field and do so on the basis of data sent into central offices without the benefit of direct contact with the records of the contractor or experience with the product and the cost thereof, and without past experience with the contractor. In spite of the obvious attempt in the wording of the bill to keep to negotiated settlements, no real negotiation would be possible. The minority report on the May Bill sets forth very clearly the basic objections to providing that no decision is final until reviewed and approved by the Comptroller General. There is little need to repeat those arguments or to repeat the reasons given by the American Institute of Accountants and its Committee on War Contract Termination in favor of restricting the activity of the Office of the Comptroller General to the examination for legality and for fraud. It is an interesting thing that their own bill, which is reported out favorably in favor of the Comptroller General, is a minority report objecting to that, which is signed by just half of the members of the Committee. That minority report, incidentally, is an extremely good presentation of the arguments against the participation of the Comptroller General from the standpoint of judgment, and there is little need to repeat those arguments here.

I rather depended on the preceding speaker to talk a little bit more about the subject of the Comptroller Gen-

eral than he did, and perhaps I was a little optimistic on that because I learned before that, in times of controversy, the services sometimes are a little reticent about presenting their point of view in public; but when I found that the Commander wasn't going to cover the subject so soundly as I knew he could, I dug up a written memorandum of the Comptroller General in which he stated his position, and I would like to interpolate here to a very brief extent.

In this particular letter, the Comptroller General said: "The audit in this office under expansion of cost-plus-fixed-fee contracts has disclosed that directors and other officers of the contract agencies who were charged with determination of what would constitute the proper costs thereunder had approved payments which in no way could be said were reasonably incident to or necessary for the performance of the contract work." Hence he goes into this demonstrated liberality and laxness of these same contracting officers or other added officials who may be charged with the obligation of determination of costs under contract termination. I am convinced that they will allow contract payments which will control millions of dollars.

If the Comptroller General's statement would be determined solely on the basis of this question, he would no doubt be excluded from a real examination of the facts because he has not made a demonstration of actual facts in support of such a broad statement.

Again the unfamiliarity of the General Accounting Office with generally recognized commercial accounting practices, which is a generally agreed basis on which these claims should be settled, as set forth in a letter from the Comptroller General to a Congressman, part of which is quoted as follows; the generally inclusive formula therein as set forth for determining cost, includes such items as: "repair and depreciation of office equipment, contributions to local charities or community chests, fees and dues to trade associations", etc., "expenditures in connection with employees' welfare activities"—and other expenditures connected only indirectly with the performance of the contract; but I seriously doubt the wisdom of applying it, in reference to these contracts, as a yardstick for use by the Comptroller General's Office to determine what constitutes a claim in a cost-plus-fixed-fee contract. It is perfectly clear that the Comptroller General's ideas of reasonable and necessary expenses in recognized spheres of accounting practices and business practices are so far from general practice that he just hasn't, it seems to me, the concept, the training nor the background which permit him to enter into the allowance of items on the basis of judgment.

However, I am not going to take the time here to discuss all of the items pro and con in connection with the Comptroller General. It's not a simple thing. But there does seem to be one result of the examination by the Comptroller General for fraud which has not been emphasized to the extent it deserves. The provisions of the Murray bill, the provisions of the Vinson bill, the Baruch-Hancock group, all suggest that the Comptroller General be written into determination procedures from the standpoint of the examinations for legality and for fraud, and the implications of writing the Comptroller General in for fraud I don't think are clearly understood.

Everyone agrees that the examinations made by the services should be adequate to give protection to Government funds and that every reasonable investigation should be made. That is the intent of the procedures already developed, and I think we can assume that it will be the actual

practice as well. Everyone agrees that the Comptroller General should examine termination settlements for legality and for fraud, as is his traditional function. Everyone now agrees that the files of each settlement should be available for his examination, and that in case of suspected fraud he could examine records and accounts of the contractor and for that purpose that the records should be kept for five years. In case he finds fraud or has reason to believe fraud exists, he should report to Congress and to other interested Government agencies. Everyone would agree, I think, that if we could be sure that the procurement agencies could and would do a careful, intelligent job, we would not need a second audit; but the fear has been expressed in Congress that those agencies would not do that kind of a uniformly careful job. I don't know why it should be assumed that one branch of the Government would be more careful of public funds than another, but, granting that, it is my point that the constant checking by the Comptroller General for fraud will amount to a constant policing of methods and operations in connection with termination, and that he constantly will be in a position to report to Congress if he finds laxity, improper care, inadequate supporting data or other evidences of waste not involving fraud. Thus Congress can be in possession of constant reports from the Comptroller General as to the kind of a job that is being done by the procurement agencies, or at least when the Comptroller General believes that the job is being so inadequately performed that Congress should be advised. I emphasize again that this is not something new which I am proposing, but some thing which I believe is inherent in the inclusion of the Comptroller General in termination procedures to the extent of examinations for suspected fraud.

Since the Comptroller General would be little restricted in his investigations for fraud and could keep in constant touch with current settlements beginning at an early date or just as soon as he could train a staff to do it, Congress could act as soon as action appeared to be warranted without waiting until after the war. On this basis the Comptroller General should not sit on any war contract termination board or advisory committee and should not participate in any way in administrative decisions. He should keep himself in a position to be completely objective in his criticism. This would leave the termination agency in a position to make settlements that would be final except for fraud and free to develop procedures for prompt settlement, and yet give Congress almost immediate information if the procedures were breaking down. This protection automatically flows from the provision that the Comptroller General is to review only for fraud and legality. It is, in my opinion, an extremely strong safeguard which has not been sufficiently understood. In other words, I think by that clause Congress will find that it is inherent in the procedure to get a great deal more out of the work of the Comptroller General than Congress or the public expects.

Let me turn now to the Murray Bill which is now before the Senate Committee on Military Affairs. This bill appears to deal with the recommendations of the Baruch report and embody the results of studies by the George committee as well. Generally speaking, the bill appears to be satisfactory. As to the accounting phases, I think it is eminently satisfactory; but some of the paragraphs touching on accounting and auditing are so important that specific discussion of them appears warranted.

The bill would provide that the examinations and review of termination settlements by the Comptroller

General should be limited to illegality of payment and fraud and, as I said before, this is incorporated in the Murray Bill. This seems to be sound.

There is a provision that inventories must be approved of and instructions issued for their disposition within sixty days of submission of a list by the contractor, or the contractor shall have the right to move those inventories at Government risk and the list shall be prima facie evidence of the items included. We, as accountants, have learned that inventories that are carefully planned can be test-checked rather readily, but that the procedures and the listing should be in accordance with the plan agreed upon in advance between the auditors and the company. With the number of material inspectors in the employ of the Government, there is no reason why inventories should not be promptly tested by the Government; so that the checking and verifying certainly need not interfere with the disposal of the inventory within sixty days or even thirty. The problem of inspection of inventories with these material men around doesn't seem to me to be too great. This sixty-day provision should not work a hardship upon the Government and should, in my opinion, be finally included in the bill.

The bill would make possible settlement of claims on an over-all company basis or as a group and the assigning of any war contractor to one contracting agency who may act for all in settlement. This seems to accountants to be a highly desirable provision, and it is to be hoped that under this permission it will be possible to work out effective detailed procedures. As accountants we can appreciate better than most, I think, the tremendous saving in time which would result if it were unnecessary to distribute joint costs between each individual contract or if it would be unnecessary to check out in detail the accuracy of the distribution of direct costs to various contracts. We can appreciate better than most, I think, the tremendous confusion that would result from audits by various Governmental agencies, or by several Governmental agencies and several prime contractors. There is a large number of complex situations where there are many contracts with many different agencies, and while there undoubtedly are legal and administrative difficulties in providing for group settlements or over-all company settlements, the goal is so very much worth while that it is to be hoped that such procedures are made available in appropriate cases. Nevertheless, it seems to me that over-all or group settlements are at their best only in a period of general contract termination, and that their applicability may not be very great in periods of revamping and readjustment of procurement such as appear to be now going on.

The bill provides that contracting or finance officers shall not be held financially responsible for decisions made in good faith. With termination procedures being developed as they are, this provision seems to be entirely warranted and certainly is necessary in the interest of prompt settlements, for the bugaboo of financial responsibility in the past has been a tremendous deterrent to prompt decisions.

The bill also provides for another matter which has been of concern to accountants from time to time. There have been various prohibitions against the giving of advice by Government people dealing with termination to contractors, particularly with respect to any advice that might increase the claim. This has always seemed to accountants to be not only unfair but unwise. It is a good deal like asking to have audits and ex-

aminations made in a vacuum. It is so practically impossible that I suspect it has not been too closely followed. But the problem of filing termination claims is new, the contractors need education thereon, and the provision of the bill that the contracting agency may assist war contractors in preparing claims is so highly desirable it is to be hoped that this will be retained.

They're all looking at their watches up here on the platform. I don't know, maybe I'm talking too long.

The bill specifically provides that where, in connection with the settlement of any termination claim by a contracting agency, any war contractor makes settlements of the termination claims of his sub-contractors, the contracting agency shall limit or omit its review of such settlements with sub-contractors to the maximum extent compatible with the public interest. The agency (1) may approve such settlements with sub-contractors upon such evidence as it deems proper, (2) shall vary the scope of its review according to the reliability of the war contractor, the size of such claims, and other relevant factors, and (3) shall authorize war contractors to make such settlements with sub-contractors without review by the contracting agency whenever the reliability of the contractor, the amount or nature of the claim, or other reasons appear to the contracting agency to justify such action. This is a highly important section. It permits, for instance, the utilization of public accountants' reports to the extent such reports can be helpful. It permits normal business treatment of normal claims. It permits complete delegation of authority within proper limits to proper prime contractors. The War Department has already authorized contracting agencies to delegate authority in settlement of claims up to an amount of $10,000. This bill would seem to permit even greater extension of the amount in appropriate cases, but it is even more important in that it gives specific authorization for the elimination of investigation for small claims where the amount of the claim would not justify the cost of the examination. For instance, typical figures indicate that close to half of the claims of subcontractors can be expected to be under $500 each, and that more than 80% can ordinarily be expected to be under $10,000. Of course the remaining percentage of the number of claims is by far the largest percentage in dollar volume, but the permission to give special treatment to small claims will eliminate a tremendous amount of auditing and other checking.

Let us move now to the treatment that is given to the problem which is perhaps of greatest interest to us as accountants — the determination of costs. The bills before Congress provide substantially for delegation to the head of contract termination of the authority to establish methods and standards for determining fair compensation of war contracts on the basis of actual, standard, average or estimated costs or a percentage of the contract price based on the estimated percentage of completion of work under the terminated contract, or under any other equitable basis as he deems proper. All provide that to the extent such methods and standards require accounting they shall be adapted as far as practicable to the accounting systems used by the war contractors if consistent with sound accounting practice. This will undoubtedly prove a very helpful provision, since it gives approval to those systems of accounting that have proved satisfactory and should for individual businesses in the conduct of their own affairs and yet specifically requires that those systems be consistent with sound accounting practice. The proposed Vinson Bill spells out the determina-

tion of costs in considerably more detail than does the Murray Bill, but the general principles are the same and the details are substantially those set forth in the Statment of Principles for Determination of Costs upon Termination of Government Fixed Price Contracts approve by the Joint Contract Termination Board on December 31, 1943. In view of the general agreement on cost philosophy, it is reasonable to assume that the general principles as indicated by the documents already issued can be expected to continue.

The basic principle, of course, is the allowance of costs that are applicable to the contract in question. This, however, is not to be interpreted in the same rigid way as has been customary for cost-plus-fixed-fee contracts, but rather as the allowance of general business expenses, which can undoubtedly be considered as those expenses necessary to running a business that is carrying out war contracts. This contemplates, of course, the allowance of all direct items and specifically necessary indirect items, and provides also for other specific items in reasonable amounts in the light of prewar practice. This is particularly true of institutional advertising and research and engineering expenses, and it would apply also to other items of like character.

Costs are to be computed generally in accordance with the system of accounting regularly employed by the company, provided that such systems of accounting are in accordance with sound accounting practice or to the extent that they conform to recognized commercial accounting practices. It seems to me that the general effect of this is to require that the cost and accounting practices of the individual contractor must be tested against generally recognized practices and that they must be tested against and be in conformity with sound cost accounting principles. This is particularly important since cost systems have generally been devised for a peacetime product and to provide information for the management and have not been concerned with providing information for outsiders. They have not customarily dealt with all the costs that will be allowable upon termination. In many cases they have not needed to be accurate for the allocation of costs between departments or between products. In other cases, standard costs were not customarily tested against actual costs, nor were the standards set on a basis of the total anticipated costs. All this means that the cost accounting system of the contractor will have to be examined from the standpoint of whether it does result in at least an approximate determination of the total cost and whether the allocations of joint costs are made upon a basis which would be approved by a group of trained cost accountants with an objective approach. Incidentally, one of the best articles I have seen on the detailed discussion of costs and the preparation of claims is one which appears in the last issue of the Bulletin of your New York State Society. Those of you who are interested in the problem and who haven't yet read that should do so. The article is by J. K. Lasser and is a leading article in the last issue.

It is an unfortunate fact that termination claims submitted to date have been on a basis that have required a cut in settlement of between 30% and 40%, the variation in percentage being due to the fact that the initial indicated percentages of around 40% are being gradually reduced, and there are some indications that the average cut is getting down below 33⅓%. (I noted in a recent report of the Army that there is an indicated cut of 26%, but it is a little hard to figure out just how that applies.) I think this is due to several causes, the chief one of which is the

fact that the ground rules were not thoroughly understood either by the contractor or by the Government and that the Government had not been able to educate the contractors in advance of the filing of the claims. As the rules become better understood, this percentage will undoubtedly drop much farther. I think however, there must be an added reason in that; in an area of doubt, contractors tend to claim the higher side of that doubtful area. I suspect, too, there may have been many cases where there just was no knowledge of recognized accounting practices and no attempt to bring the company's practices in line with sound principles. I don't think that much of the cut is an arbitrary disallowance by the Government of items of cost that should have been allowed to the contractor, though, like all averages of this kind, it would be unwise to draw very specific conclusions from them. Nevertheless, the percentage is still far too high and shows a need for education of the contractor, training on the part of the Government personnel, cooperation between the two interests in the preparation of the claim; and shows also the need of cold, objective analysis on the part of those who may be advising the contractor in the preparation of the claim.

In the interest of better understanding, it is essential that there be uniform cost interpretations issued on behalf of the settlement services. Fortunately there is a subcommittee of the Joint Contract Termination Board to deal with this subject. As Mr. Peloubet told you, the speaker here today—Commander Stewart—is Chairman of that subcommittee and, from personal knowledge, I can tell you that subcommittee is made up of men with a sound knowledge of cost and general accounting. It is part of the procedures that this committee will issue from time to time individual cost interpretations on points that are causing the greatest difficulty. It is hoped that these releases will not only deal with broad problems but will deal also with specific problems in such a way that the decisions will serve as criteria for other comparable items. It is to be hoped, also, that all cost instructions issued to the people responsible for termination settlements will be made available to the general public. It will me infortunate if the accountants in the various Government offices dealing with termination are operating under accounting instructions which are not available to the general public. It seems to me that this would be a good deal like asking a taxpayer to make out tax returns these days without having the benefit of the tax services or perhaps without even having any regulations. There is some indication that the first group of cost interpretations may be released shortly.

I have not taken the time here to discuss the allowable and unallowable costs as they have been set forth in detail in the Statement of Principles. There is, however, one specific paragraph which should be discussed. That has to do with the disallowance of expenses as part of a termination claim when those expenses have already been considered in connection with a previous settlement under the Renegotiation Act and have had the effect of changing the amount that would otherwise have been refundable. In those cases it is the position of the Government that the costs should not again be allowed as part of a termination claim. This seems to mean in effect that the termination claim can deal with expenses of a prior year, such as overhead or high starting load costs, only to the extent that for purposes of renegotiation they have been carried forward as assets or deferred charges at the beginning of the current fiscal period. This is going to be a very difficult require-

ment to handle, but in theory it cannot be objected to. It is difficult to see just how this will work out for those companies that were not required to make a refund under renegotiation, since in those cases information will have to be available as to whether the chargeoff of the items in question was in itself the cause of no refund. Commander Stewart spoke about that himself and I won't take the time to read my comments here.

The public accountant appears to be participating in termination settlement in a greater and greater degree. As he himself learns by experience he is being called upon more often to advise his clients in respect of the claims and to participate in their preparation. He apparently is not being called upon very often to certify termination claims in total and, if the recommendation of the Committee on Auditing Procedure of the American Institute of Accountants is observed, he will not make an accountant's report on the entire claim, including profit, but will deal only with those elements of cost that are within his province. There is, in my opinion, no present basis for believing that the report of an independent public accountant approving a termination claim of a prime contractor will necessarily be conclusive for the contracting agency. The Government agencies will have to examine claims to the extent they believe appropriate. It is, of course, quite probable that claims for which public accountants take responsibility as to the costs involved will require less checking and will be processed more quickly than will be some other claims. But this will be true only if the public accountants as a group show a complete understanding of the ground rules and an ability to approach the problem on a completely objective basis and make their reports to bring out the information needed by the contracting officer.

With respect to the claims of subcontractors to prime contractors, the requirement of direct Government examination does not exist to the same degree; and it may well be that public accountants' reports will be used quite broadly in the settlement claims between subcontractors and prime contractors. The Murray bill, to which I referred earlier, seems to provide a statutory framework which will make this possible. Nevertheless, public accountants' reports in this connection will only be useful and eventually will only be used if the public accountants show again a thorough knowledge of the rules and regulations and of recognized commercial accounting practices, and if they approach the problem with the same objective viewpoint that they bring to their ordinary auditing practice.

I do not need to point out that the future of independent public accounting is going to depend to a great extent upon the intelligence and independence which the accountant displays in assisting clients in the preparation of termination claims. The American Institute of Accountants and State Societies such as yours have a responsibility to see that the public accounting profession is fully advised on the problems of termination settlements and is thoroughly alert to the responsibility imposed upon it. In this connection, the Institute's Committee on Auditing Procedure has issued a bulletin which makes many suggestions with respect to auditors' reports on termination claims. More recently, a letter has gone from the president of the American Institute of Accountants to all members of the Institute, emphasizing the responsibility upon the public accounting profession—or it is in the process; it is being mailed.

We as accountants are all inter-

ested in bringing down the percentage of disallowances from 33⅓% to a nominal amount and in reducing the time required in the preparation of the claim and in the processing of it after it has been filed. If the profession is to do that, it must thoroughly understand the problems in connection with termination claims. Unfortunately, that means hard work and time, when the pressure is already severe. The flesh, I am sure, will be equal to the task which the spirit of the accounting profession will assume in the interest of a prompt and orderly transition from industry on a war basis to industry on a peacetime basis. God grant that the transition comes soon!

Problems and Procedures Arising from the Termination of War Contracts

By DAVID DAVIDSON

I SEE from the program that I am scheduled to describe war contract termination procedures.

With the realization of the need for change in procedures and the further realization that failure to change quickly and perhaps basically could result in the creation of a false sense of security, I will not presume to set a pattern of the shape of things to come.

I would like to make it quite clear that anything which I will say is my personal opinion and should not necessarily be construed to represent the policies or the practices of my own Company.

General

The problems incident to the termination of war contracts cover the whole gamut of business enterprise. They are not only problems of individual contractors. They strike at the roots of our economic system and the possible social repercussions should not be minimized. Individual contractors must, of necessity, develop termination procedures, not only in their own immediate interests but rather from the broader point of view of preventing what otherwise could be social chaos and economic disaster.

The effective negotiation of settlements of terminated war contracts has two main objectives; namely, the preservation of the financial soundness of a contractor and the maintenance of a sound national economic system.

Extent of the Problem

Cancellations to date have exceeded in volume the cancellations arising from the First World War. A survey conducted by the War Production Board based on 7,675 contracts out of 9,502 which had been terminated as of September 30, 1943, disclosed that $51,284,000 in claims had been settled by the payment of $39,351,000, i.e. settled for 77%. It has been estimated that contracts amounting to seventy billion dollars will eventually be cancelled by the War Department alone. Most of us have some knowledge of the confusion which existed after the First World War and the enactment of the Dent Act in 1919 for the purpose of giving cancelled contracts validity in order that contractors would recover their damages. After the First World War, settlements were made for a very small percentage of the face value of the claims. Settlements arising from recent terminations should and will, in all probability, result in the recovery of substantially all incurred damages. In this respect the Governmental agencies are pledged to compensate contractors for complete damages in the interests of maintaining economic and industrial equilibrium.

The increase in cancellations which might be anticipated is not a true measure of the extent to which claims will increase, for today many contracts which have been cancelled do not become the basis of a cancellation claim for two principal rea-

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sons: First, sufficient additional orders are on hand for similar material which enables a contractor to divert the cancelled material to such orders. It is reasonable to assume that upon the cessation of hostilities the opportunity to divert will be considerably less frequent and substantially all contracts which will be cancelled at that time will result in cancellation claims. In the second place, as long as the Renegotiation Act is in operation, many contractors may continue to waive their right to recover damages on terminated contracts on the theory that the absorption of the loss incident to termination will operate to reduce the amount payable pursuant to the Renegotiation Statute.

Contractors must of necessity approach this problem devoid of the fears of loss. This attitude, of course, can best be supported with the conviction that claims for damages are fair and reasonable and that the accounting facts are available in substantiation of the claims.

Recent Regulatory Developments

Prior to 1939, the possibility of contracts being terminated incident to the cessation of hostilities was not anticipated and consequently no termination clauses were included in supply contracts. Gradually the Army, the Navy, and the Maritime Commission sensed the need for such clauses and in a relatively short period of time they became commonplace. The several clauses in use by the different agencies were not uniform, in fact, the same agency used successively different clauses. For example, while generally the measure of damages was the costs incurred plus a reasonable profit on material in process together with the original contract price applicable to completed units which were undelivered, nevertheless the definition of costs varied. In some cases costs were to be determined in accordance with TD 5000, while in others normally acceptable accounting practices controlled. In addition, some clauses provided that a reasonable profit would be allowed in addition to the cost of material in process, while other clauses specified that certain definite percentages should be added to such costs and in other instances the percentage of profit was to be based on the percentage which could have been anticipated had the contract not been cancelled. The need for uniformity was, of course, highly desirable and three months ago the Baruch Committee issued a uniform termination article which was authorized for use by all procurement agencies in prime contracts.

Significance and Desirability of Termination Clauses

Termination clauses generally limit the common-law rights of the contractor in the amount of damages which he can recover. It might therefore appear that termination clauses were undesirable. Be this as it may, the fact remains that a contractor will not be heard to object to the inclusion of a termination clause in his prime contract. However, it should be recognized that the terms of such a clause are applicable only to the prime contract and cannot be imputed to subcontracts unless the prime contract termination clause has been included in the subcontract either specifically or incorporated by reference. It follows therefore, that a subcontractor in the absence of a termination clause in his contract may proceed to recover his damages based on his common-law rights, which in substance include not only his incurred costs, but all the profits which he would have realized had the contract been completed rather than merely a fixed percentage on the costs incurred.

Methods of Settlement of Terminated Contracts

Regulations have been issued by the Army prescribing in detail the methods of effecting settlements on terminated contracts. I refer to Procurement Regulation 15. It is believed that if similar methods are followed with respect to contracts with agencies of the Government other than the Army that such methods and practices will be acceptable to such agencies pending the development of regulations specifically applicable to such other agencies or the issuance of a uniform termination manual applicable to all agencies.

Basically there are two methods; namely, the formula method and the negotiated method. The practical difference is that under the formula method the amount of the claim must be determined with precise accuracy and it is subject to detailed audit by the agency against whom the claim is filed, whereas, the negotiated method theoretically is not subject to detailed audit, therefore, many items which are controversial may be settled through the process of negotiation rather than following the cumbersome and burdensome practice of substantiation through cost analysis and accounting research. Since the formula method of settlement is generally impractical and seldom followed, suffice for me at this time merely to mention it. Under the negotiated method claims may be filed on the basis of the total cost method or inventory method. Under the total cost method consideration must be given to that portion of a contract which has been completed and shipped in addition to that portion which has been cancelled and in the process of production at the date of cancellation. The amount of the claim under this method is determined by adding the cost of the material previously shipped on the contract together with the cost of the material on hand, whether completed or in process of production, to the aggregate of which cost is added a reasonable profit and from the resulting total the amounts paid for items shipped prior to the date of cancellation is deducted. The difference is the amount of the claim.

Under the inventory method of effecting a negotiated settlement, no consideration is given to either the sales proceeds or the cost of that portion of the contract which was shipped prior to the date of cancellation. The amount of the claim is segregated into two elements; namely, the completed material on hand ready for shipment at the original contract value plus the cost of producing incompleted material together with a reasonable profit on such cost. The total cost method is, of course, preferable in those cases where accounting records do not disclose the costs applicable to the several units of the contract. The filing of a claim on the basis of the total cost method operates to renegotiate the profits realized on the units which were shipped prior to the contract being terminated.

Generally speaking, Governmental agencies request that information based on the formula method be submitted in substantiation of a claim although a negotiated settlement results. This, of course, is a practical way of disclosing the facts in sufficient detail to support a negotiated settlement and by this process sufficient facts are made a matter of record to substantiate a negotiated settlement thereby relieving the contracting officer of responsibilities which otherwise he would be obliged to assume in negotiating a settlement in the absence of the facts required under the formula method. It is reasonable to assume that if contracting officers were relieved of their personal liability incident to the negotiation of a settlement of a cancelled contract that the need for de-

tailed cost information would be minimized. I do not infer that contracting officers are going to extremes for the purpose of avoiding personal liability. They are merely taking reasonable steps to avoid personal liability coupled with their desire to obtain sufficient facts to enable a reasonably prudent person to negotiate an equitable settlement.

Short Cutting Accounting Detail

As previously mentioned, a contractor can recover the original contract value of completed units on hand as of the date of termination of the contract under the inventory method of settlement. It is presumed that he is recovering, in substance, the cost plus a reasonable profit on such costs. It would follow therefore that a contractor who processes material which is marketable at its various intermediate stages of production could eliminate a substantial amount of detailed accounting work if recovery of damages on "in process" and marketable material were made on the basis of the published market price of such "in process" and marketable product rather than by an analysis of the cost of production to which cost would be added a reasonable profit. This, I believe, is a practical method of determining the amount of cancellation claims in those cases where the product is marketable and is generally sold in its several stages of production. This basis of settlement would appear equitable and certainly very practical where the contract does not contain a termination clause which specifies some other basis, and of course in all cases where a negotiated settlement results.

Mitigation of Damages

Basically a contractor must exhaust all reasonable efforts to mitigate damages. It is believed that failure on his part so to act will jeopardize his right to recover the damages sustained. The contractor therefore must divert cancelled material to orders from other customers where this is practical. While he is not required to sustain losses in diverting the material, nevertheless, practical business judgment may, in many instances, dictate the incurrence and absorption of certain losses by the contractor which in many instances will be more than offset by a realization of intangible benefits. To illustrate: Where a contractor is able to divert cancelled material and he by this process sustains an unusually high scrap loss for which he recovers no additional compensation in the contract to which the cancelled material was diverted, he, nevertheless, has effected a faster turnover and has avoided possible congestion resulting from the accumulation of cancelled material in his plant, which congestion could, from a practical operating point of view, disrupt daily production operations.

When cancelled material is diverted the contractor assumes a credit risk different from that which he assumed when the original contract was entered into. It is doubtful if any loss incident to the assumption of a greater credit risk is recoverable unless the diversion has first been approved by the superior contractor and the contracting officer. As a practical matter, in this day of congested operating schedules and planned production, it not infrequently happens that cancelled material can be diverted provided immediate authority is obtained and delay in obtaining such authority will for practical operating reasons make it at least impractical, if not impossible, to divert later. For this reason it often becomes necessary for a contractor to assume a new credit risk without prior authority and in such cases it would seem

that credit losses could not be recovered in the form of a cancellation claim. It is feared that the assumption of such credit risks must be made as a contribution of industry to the war effort. In the event cancelled material is diverted to orders from other customers and such other orders are themselves cancelled after the cancelled material has been appropriated to the second order, it would appear that the claim against the first customer has been waived and the right of recourse is against the customer to whom the cancelled material has been diverted.

The responsibility of a contractor to exercise reasonable care for the cancelled material is coupled with his obligation to mitigate damages since failure to exercise such reasonable care may jeopardize his ability to divert or dispose of cancelled material to the best advantage of his superior contractor or Governmental agency and negligence in this respect could, it is believed, at least jeopardize his right to recover any portion of the claim.

When Should Efforts to Divert be Discontinued

Again from a practical point of view and in the interests of the war effort, diversions should be attempted as long as the cancelled material remains on hand and until authority to scrap has been obtained. Frequently it will happen that material will be diverted subsequent to the filing of a claim against a customer. Where such subsequent diversions are made without authority from the customer, and as you know authority is not required where the claim applicable to such diverted material will be waived, it is necessary that the customer against whom the claim has been filed be immediately advised of the diversion in order that he will have knowledge of the facts in the event he chooses to check the statement of physical inventory filed with him at the date the claim was filed. Failure to so notify the customer could prove embarrassing to a contractor since discrepancies would naturally arise at the time the customer physically checked the inventory.

Where a subcontractor is instructed by a superior contractor to deliver cancelled material to a third party, such subcontractor should question whether or not by so doing he is divesting himself of a lien and security for payment of the claim. It is true the security may only be the scrap value of the cancelled material, however, there are many instances, particularly in the steel industry, where the scrap value may be as much as 40% of the amount of the original claim. It is not suggested that a subcontractor under such circumstances should refuse to deliver the cancelled material. It is suggested, however, that necessary precautions be taken to be reasonably sure that the claim will be paid, particularly where the superior contractor is a doubtful credit risk and it must be realized that the credit standing of many contractors will change substantially, particularly when the volume of cancellations increases.

Apart altogether from the purely financial aspects involved a contractor must view the problems in their social, economic, and patriotic significance and accordingly take all action within reason which will contribute towards those greater and more fundamental objectives.

Collection of Claims

The several Governmental agencies will make advance payments within a reasonable time subsequent to the filing of claims. However, advance payments are not full payments and a contractor must be reasonably aggressive in collecting final settlements. Today where many

contractors have expanded their operations considerably out of proportion to their invested capital, the danger of insolvency cannot, of course, be disregarded, particularly should the volume of cancelled contracts materially increase without a corresponding increase in new business. The development of "V" and "VT" loans has resulted in many contractors having hypothecated a substantial portion, if not all their assets, as security for loans thereby endangering the right of a subcontractor to collect his equitable cancellation claim. As the matter stands today, settlement of a prime contract claim and payments to the prime contractor does not necessarily insure payment in turn by the prime contractor to his subcontractor although legislation is now in process which will, if enacted, provide for direct payment by Governmental agencies to the subcontractors. In the absence of such legislation it seems only reasonable that settlements between prime contractors and Governmental agencies should be publicized in the interests of enabling the subcontractor to proceed immediately to collect his cancellation claim from the prime contractor.

Legislation which will provide for a horizontal method of settlement, which will permit subcontractors to negotiate direct with Governmental agencies, as contracted with the present vertical method, under which a subcontractor is permitted to negotiate exclusively with his own superior contractor, would solve many of the present day problems. Such legislation would eliminate credit risks now assumed by subcontractors and substantially accelerate settlements, and expedite the disposition of cancelled material. I do not suggest that horizontal settlements will be the panacea for all of our current difficulties but I do not submit that the present vertical procedure operates to pyramid the problems to the point where the only security can be found by those contractors who fortunately form the apex of the structure.

Differences Between Theoretical and Practical Solutions

Most of you will have read Procurement Regulation 15 issued by the Army and the Technical Accounting Manual. Those documents are, in my opinion, masterpieces. They have been "best sellers". Even a hasty review of those publications will impress you on the orderliness with which procedures have been devised for the purpose of apparently settling cancellation claims. However in attempting to obtain practical application to the highly commendable procedures the difficulties just begin to develop. Governmental district offices are required to act and the natural impulse of an individual to avoid violations retards progress in negotiating settlements. This has been particularly true with respect to those provisions of the regulations which apparently make it possible to readily obtain authority for the scrapping of cancelled material which obviously is of no immediate value in the war effort but which, if kept out of circulation, could in fact retard that effort. It must be admitted that it requires courage to authorize the physical scrapping of cancelled material which recently was being rushed to completion and which cost substantial amounts of money. That is where we encounter the practical difference between the theoretical solution and the practical application of it. This condition is more apparent where negotiations relating to the termination of contracts must be conducted with individuals in the Governmental agencies of limited personal authority and, of course, the fact that such individuals are personally financially responsible further aggravates the inherent delays in negotiating settlements.

Experience at the end of World War I indicates that industry continued to produce war material for some considerable time subsequent to the cessation of hostilities. This condition which was economically unsound was attributable almost exclusively to the cumbersome and slow method by which the termination procedures were placed in effect. Delays were attributable both to industry and Governmental agencies. This economic waste resulted in the accumulation of surplus material which not only could have been avoided had the planning been improved and the condition anticipated but was instrumental in impairing a speedy return to commercial activities.

Accounting for Terminated Settlements

Theoretically when a contract is cancelled, the rights of a contractor immediately are changed and it might be argued, therefore, that the resulting rights should be a matter of accounting record immediately upon the termination of the contract. The contractor's rights are not measured by the amount of the inventory value of the cancelled material on hand but rather by the amount of a claim or account receivable for a larger amount. Therefore, theoretically it could be argued that the claim should be recorded and the excess of the amount of the claim over the inventory value credited to some income account or to a deferred credit to income account pending final settlement. You will note that I have stressed the theoretical rights of the contractor, however we must recognize, even in this day and age, certain basic accounting concepts. In this connection, I refer to the principle that profits must not be anticipated or should assets be inflated. Experience in recent months has proved that the amount of a claim as originally determined, where the settlement will be made on a negotiated basis, is frequently not the amount of the negotiated seetlement. In the interests of conservative accounting practices, it would seem preferable to retain the value of the cancelled material in inventory or to transfer it at its inventory value to a claim receivable account and defer further accounting until a settlement is reached or payment received, whichever event happens first. It is further recommended that the amount of the settlement be recorded as a sale and the corresponding cost of the material for which the claim is filed should be charged to cost of sales. This accounting procedure is particularly justified when it is realized that in all probability the time may not be too far distant when the volume of business measured by income arising from termination settlements may, in some companies, exceed in volume the income arising from completed sales. From a practical point of view and based on experience, the frequency with which the amount of a claim as originally determined is amended, warrants the deferring of the accounting pending the settlement of the claim.

Where a contract has been settled and it has been agreed that the contractor will retain the cancelled material as scrap then, of course, the question arises at what point should the acquisition of the material as scrap be recorded on the books. There are two possible methods; namely, co-incident with reaching the terms of settlement, or the alternative, at a later date when the cancelled material is physically scrapped. It is recommended that the acquisition of the scrap be recorded when the settlement is entered into and before the material is physically scrapped. Since the amount of the credit allowed the Governmental Agency or the customer is a credit to the claim receivable then if the accounting entry is not made until the material is physically

scrapped, the claims receivable would be mis-stated since the asset as of the date of the settlement is not a claim receivable but scrap inventory. However, I strongly recommend that contractors obtain certificates from responsible employees within their own organization to the effect that the material in question has been physically scrapped in order that a record will be established in the event that the basis of negotiating the settlement of a particular contract is ever questioned.

The acquisition by a contractor of cancelled material as scrap solely in the interest of effecting a speedy settlement where the contractor has no immediate need for the cancelled material as scrap would seem to be not only economically unsound, but would operate to penalize other contractors who are urgently in need of scrap. Therefore, a contractor should, where he himself has no urgent need for scrap in his production operatings, exhaust all effort to dispose of it by sale to others where it will be more effective in the war effort.

Baruch Committee and George-Murray Bills

It is not my intention to analyze the Baruch Committee Report or the George-Murray Bill, or any of the other several bills which are in various stages of processing through the House and Senate. However, I do want to comment on two points which to me are more than just interesting.

You will find that the Baruch Committee Report and the George-Murray Bill provide that, in substance, the Government will authorize the storing of cancelled material after the elapse of a specified number of days subsequent the filing by the contractor of inventory statements with Governmental agencies. However, in my opinion, little benefit will accrue to our economy if cancelled material is stored. It will, in substance, result in economic waste.

As the matter stands at present, contracting officers do have the authority to authorize the physical scrapping of cancelled material. Upon enactment of the pending legislation, the contracting officer will have fulfilled his responsibilities simply by advising the contractor to take an inventory, box it, and store it in some warehouse. I fear that the storing of cancelled material at the expense of the Government may be only a sedative to individual contractors which may actually aggravate an economic sore and cause it to fester.

Let me refer for a moment to the statement of cost principles set forth in the Baruch Committee Report. I will not take up your time by reciting the several principles involved other than to quote Paragraph 3 (e) as follows: "Costs which, as evidenced by accounting statements submitted in renegotiation under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, as amended, were charged off during a period covered by a previous renegotiation, may not be subsequently included in the termination settlement if a refund was made for such a period, or to the extent that such charging off is shown to have avoided such refund."

Difficulties develop in giving practical application of this provision. Let me illustrate—let us assume that overhead which was incurred in 1943 was considered as an element of cost in determining the amount payable under the Renegotiation Act, and that excess profits were repayable under the act. Section 3 (e) provides that such items of overhead cannot again be included as part of the costs recoverable under a termination settlement. If the amount of the refund under renegotiation was less than the overhead in question, then it is presumed that the amount by which the overhead exceeded the refund is deductible in negotiating a settle-

ment upon termination, however, let us further assume that no refunds were made pursuant to renegotiation. I am particularly curious to know how a contractor is able to determine whether or not the charging off of such overhead in determining the amount subject to renegotiation operated to avoid a refund since this information is within the exclusive province of the Price Adjustment Board, and strictly speaking, the contractor would be required to approach the Price Adjustment Board and ask them what their decision would have been on the renegotiation proceedings had the overhead in question not been included as a cost in their "closed door" deliberations.

Organization to Handle Terminations

In our Company an executive committee was appointed to determine matters of policy relating to terminations. The members of this committee are the Vice President of Operations, Vice President of Sales, Vice President of Finance, General Purchasing Agent, Comptroller, and Secretary. This committee is responsible for coordinating the activities of the Company with respect to the termination of war contracts and the establishment of necessary policies and procedures for controlling the settlement of terminated contracts.

A working committee has also been appointed. This committee is composed of a representative of each of the members of the executive committee. The working committee assumes the responsibility for developing necessary procedure to carry out the responsibility of the executive committee. From time to time, questions of Company policy outside the scope of the authority of the working committee are referred for consideration and decision to the executive committee.

The extent of organization within a contractor's company necessary for the efficient and expeditious settlement of claims must, of necessity, be influenced by volume. Generally speaking however, even at this stage in developments, it is increasingly necessary that a person, together with necessary personnel, be assigned to this work who can devote his exclusive attention to the problem. It is recommended that the person selected be one who is basically an accountant and who has a business point of view. Where the volume of cancelled contracts is substantial, it is recommended that the person so selected be clothed with sufficient authority to negotiate settlements and coordinate the activities of the other divisions of the company. Confusion of responsibility between the several departments of the company will inevitably lead to loss. It is not recommended that the person charged with the responsibility for effecting settlements should have the necessary qualifications to act as a production expert or a sales expert, however, the initiation of all activities necessary for the purpose of properly effecting an equitable settlement should originate with that person and clear through him.

The responsibility of the several departments of the company should be clearly defined. That department of a company which is charged with overall responsibility should exert all of its effort in effecting control and uniformity of policy within the several divisions of each department and between departments.

While the preparation of claims is essentially an accounting function, it must be recognized that the efficiency with which this work is performed depends to a large extent on the cooperation received by the accounting department from the other departments of the Company.

The preparation and substantiation of claims cannot be disassociated from the disposition of cancelled material in compliance with O.P.A.

price regulations affecting the sale of such material. Decentralization of responsibility for the several phases, each of which is a part of a complete negotiated settlement, would seem to be impractical and undoubtedly would be unwieldly and confusing. The preparation of claims should therefore be centralized under one responsibility.

Broad general policies and procedures should be reduced to writing and circulated widely among the responsible employees of the contractor and, if necessary, dependent of course upon the size of the contractor's organization, general discussions should be held in order that those who will be required to perform certain duties will be familiar with the problem involved from an overall point of view, thus they will more intelligently perform their individual specific responsibilities.

I suggest that the following procedural practices, when properly controlled by a central unit, will give satisfactory results.

Responsibility of the Sales Department

The Sales Department which originally negotiated the contract and which generally will be first to receive notification that the contract has been cancelled should immediately notify the operating department. The operating department, in turn, will immediately stop further production and determine whether or not it is possible to divert the cancelled material to other orders thus waiving the claim against the customer. If the material is diverted, no further problems exist, however, the operating department should be given discretion in deciding to what extent additional costs should be incurred in the interests of effecting immediate diversions and at the same time waive the cancellation charges against the original customer.

This is particularly true where intangible advantages can be realized through immediate diversions and where the possibility of subsequent diversion may not exist where time is of the essence.

Where substantial losses will be incurred in diverting cancelled material, the extent of such losses should be estimated and approval obtained by the operating department from the customer through the sales department to divert the cancelled material and at the same time the right should be reserved to recover the loss incident thereto from the customer.

The estimate in this case, of course, will be prepared by the accounting department, however, in many instances it will be found unnecessary to submit an estimate and it will generally suffice if the contractor can assure the customer that the claim for damages will be reduced through diversion.

The disposition of all cancelled material should be cleared by the operating department with the accounting department in order that the proper accounting records can be maintained of the status of the claim.

Operating Department

The operating department should notify the accounting and purchasing departments upon receipt from the sales department of information that a contract has been cancelled. This notification should inform the accounting and purchasing departments of the status of the cancelled material and whether or not it will be diverted to other orders with or without loss.

The notification should also advise the accounting department and the purchasing department if any special facilities or materials were acquired for the purpose of performing the cancelled contract. In addition, the operating department should express an opinion concerning the remaining useful value of such facilities or materials in light of their pos-

sible use in immediate production operations.

Reasonable care must be exercised by the operating department over the cancelled material to prevent wastage by deterioration. While for practical operating reasons, it is often necessary to expose cancelled material to hazards which might give rise to loss, it is first necessary to place the customer on notice to this effect.

Purchasing Department

This department should notify concerns with whom the contractor has placed orders where it is necessary to cancel such orders.

It will also supply the market price to the accounting department for submission to contractors where the cancelled material will be retained by the contractor. In addition, the purchasing department should obtain competitive bids from others for the sale or disposal of material and such bids should be submitted to the accounting department to enable that department to take whatever action may be necessary in effecting the settlement of claims.

Accounting Department

The accounting department, through its termination group, should determine the amount of the claims in accordance with established company policies and the provisions of contract termination clauses. It should control the cancelled material and maintain all information supporting claims filed and will be responsible for the recording of settlements in the books of account.

It should also be responsible for the approval of claims filed against the contractor by concerns whose contracts have been cancelled and the processing of such claims by the contractor against prime contractors or Governmental agencies.

Legal Department

The legal department should approve claims before submission to customers. It should also be charged with the responsibility of interpreting termination clauses.

Example of the Disposition of Cancelled Material

The contract was for several millions of dollars. The cost of the material in process at the date of cancellation was approximately five hundred thousand dollars. It was immediately realized that in all probability, the cancelled material could not be used as scrap in view of the unusual chemical analysis involved coupled with the fact that recurring orders for like material could not be anticipated. To weigh the material on hand would be a substantial burden and would require many manhours of labor. It was realized that the physical weighing of the cancelled material for the purpose of determining the inventory would be repeated when the material was disposed of as scrap by sale if a market could be found. In anticipation of this possible duplication in weighing, it was agreed with the contracting officer that the weight of the inventory would be acceptable on the basis of the theoretical weight of the material determined in accordance with standard industrial practices. This agreement with the contracting officer avoided the expenditure of several thousands of dollars and the consumption of many valuable manhours. It later developed that the contractor actually had no use for this particular grade of scrap in his business. He was fortunate after much effort in obtaining bids from others in the scrap business. The material was sold but the purchasers of the scrap were not able to absorb this tremendous volume in their current operations and it was agreed that delivery would be made from time to time at the request of

the dealers. It was realized that complete delivery would not be made for several months, therefore actual car weights would not be obtainable until actual shipment had been completed. Realizing this, the contractor again approached the contracting officer charged with the responsibility of negotiating the settlement and recommended that the negotiation be completed on the basis of the theoretical weights and that any loss occasioned by differences between the theoretical weight and the actual weight would be absorbed by the contractor and likewise he would enjoy any benefits. Upon final delivery of the cancelled material as scrap the difference in this case resulted in the contractor absorbing a loss of $202.38, which you agree is a good investment since the settlement was made several months earlier than otherwise would have been the case. It is also of interest in this particular case to mention that when the contractor invited bids from others, he requested that the bidders certify to the effect that they would use the material as scrap in accordance with all regulations of the Office of Price Administration, and the War Production Board. This is a requirement of the Army and the purpose of it is to prevent the unjust enrichment of dealers in cancelled war material.

Anticipation of Terminations

Naturally if terminations can be anticipated the return to normal business will be accomplished with less interruptions and upsetting of the economic system. With this thought in mind, it would seem desirable for contractors to review the nature of the orders which have been cancelled as a guide to the future possible trend in the type of material which may later be cancelled. By planning production, it may be possible to avoid overproduction of items which, in the light of recent cancellation experience might possibly be the subject of cancellations in the immediate future. It is suggested that perhaps additional information concerning the possibility of future cancellations is obtainable if the contractor keeps in close touch with his customers and Governmental agencies.

Conclusion

The status of regulations and legislation affecting contract termination is in a state of flux.

Again let me emphasize that we as individuals have a responsibility to industry generally and more particularly to the preservation of a sound national economic system. That responsibility can be carried out only if we as individuals realize the importance of the termination problem and obtain a perspective of it in terms of its national significance for only then will we be able to do the job as it should be done and only then will we render the most constructive service to our individual employers.

Introduction of Senator James E. Murray

By SAUL LEVY

IN planning our program on the Termination of Government Contracts in War and Peace, we have been almost over-awed by the paramount importance of the subject under consideration and by the monumental difficulties which it involves. We were similarly impressed with the immediate necessity for dealing with these problems. Contract termination is not merely a post-war phenomenon. The dollar volume of terminations which have already been made effective far exceeds the dollar volume of contract terminations at the end of World War No. 1. This circumstance has given us a limited preview of what an avalanche we shall have to contend with when hostilities cease. It has given all concerned the opportunity to deal immediately with these problems on a sizable scale. It has compelled us to develop techniques which will serve us later, as well as now. It has emphasized the urgent need to formulate a legislative framework and establish administrative machinery to enable us to deal effectively with the far greater volume of termination claims which will confront the nation some future day.

The successful conversion of industry to a war basis carried with it the responsibility for the orderly reconversion of industry to a peace basis. We are fighting for the preservation of our system of free enterprise, and total victory must bring with it a healthy transition back to a sound peace economy. It has been said that in modern total warfare there is but one front; that the home front and the fighting front are merged together. In a similar sense it may be argued that preparation for war and preparation for peace are both phases of a total war program. The degree of emphasis may shift with the development of the military situation, but we cannot ignore preparedness for peace and achieve total victory.

Certified public accountants feel that they have an important potential responsibility in the administration of contract termination. Everyone recognizes the wisdom of expediting these matters so as to avert economic paralysis. It is equally obvious that billions of public funds cannot be disbursed in payment of claims against the Government without reviewing the supporting factual data to an extent which adequately protects the public interest. The books of account and cost records from which termination claims are prepared are, to a large extent, already under audit by independent certified public accountants. Such audit work usually can be integrated into the preparation of termination claims and coordinated with the requirements of government. Where the claim is thus supported by the report and opinion of an independent certified public accountant, government can rely thereon and be relieved of a large part of its administrative burden. Duplication of audit work can be substantially avoided. Both government and industry in this way can progress more effectively toward the attainment of the dual objectives of speedy final settlements and compliance with adequate protective procedures.

In our afternoon sessions we have heard from representatives of the Army, Navy, industry and the accountancy profession, discussing principles and policies of contract termination as they have been applied to actual cases that have already arisen. Tonight we are privileged to

listen to a discussion of the subject from the broad viewpoint of the legislative branch of our Government. Our distinguished speaker is the co-author of a bill recently introduced in the Senate of the United States, known as Senate Bill No. 1718 and described as "a bill to provide for the settlement of claims arising from terminated war contracts, and for other purposes."

The introduction of this bill was preceded by extensive hearings before the Senate Subcommittee on Contract Termination, of which our speaker is the Chairman. No one in public life is making a more valuable contribution toward solving the problems we are discussing tonight, and no one can speak with greater authority concerning the purposes and policies expressed in this all-important pending legislation. We are highly honored to have him with us tonight.

It is a great privilege to present to you the Senator from Montana, the Honorable James E. Murray.

Proposed Legislation Dealing with the Termination of War Contracts

By HONORABLE JAMES E. MURRAY
United States Senator from Montana

I APPRECIATE the opportunity of appearing before this meeting of the New York State Society of Certified Public Accountants. I will confine my remarks this evening to a discussion of proposed legislation dealing with the termination of war contracts. The prompt and equitable settlement of war contracts presents largely questions of accounting. I cannot think of a more appropriate forum for the discussion of such a subject than this meeting of your organization.

The success or failure of any program for quick settlement of war contracts will depend on the character of legislation which may be worked out and the preparation which the accounting profession and its clients will make in anticipation of the task.

The termination bill about which I wish to talk to you—S. 1718—is entitled:

> "A bill to provide for the settlement of claims arising from terminated war contracts and for other purposes."

This bill was introduced by Senator George and myself. It was prepared after extensive hearings held in October and November, 1943. In the course of the hearings, it was demonstrated that the methods of settlement now employed are hopelessly inadequate to cope even with the limited present-day termination problems.

Under existing legislation and under existing termination policies of the procurement agencies, the settlements of terminated contracts are being handled in an inefficient and unsatisfactory fashion. Not more than 10% of the sums estimated as due on all termination claims submitted to date has been paid. An increasingly large volume of claims has been pending for over 6 months and many claims have remained unsettled for over a year. Adequate working capital is not being provided during the period between termination and final settlement. Materials released through contract termination have often lain in plants for months and months before removal. The lack of appropriate contract termination legislation augurs ill for the inevitable period of transition from war to peace.

Thousands of manufacturers who have contributed effectively to the war effort, and particularly the smaller subcontractors, are facing the prospect—upon termination of their contracts—of being financially crippled and rendered insolvent by the tedious process of settlement.

S. 1718 is intended to provide a firm legislative basis for the quick and equitable settlement of claims arising from termination of war contracts;—to provide for adequate interim financing,—and for the prompt removal of materials from war plants.

In order to achieve these purposes, S. 1718 establishes an Office of Contract Settlement to be headed by a Director. It will be the function of the Director to prescribe policies which will enable the procurement

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Presented at the April 10, 1944 meeting of the New York State Society of Certified Public Accountants.

agencies to use all possible methods suited to the needs of different industries for the purpose of effecting speedy settlements, while, at the same time, safeguarding the Government against waste of public funds through extravagant expenditures. In this respect, Section 7 of the bill provides that "each contracting agency shall establish methods, suitable to the conditions of various classes of war contractors, for determining fair compensation for the termination of war contracts on the basis of actual, standard, average, or estimated costs, or of a percentage of the contract price based on the percentage of completion of work under the terminated contract, or on any other basis, as it deems appropriate." It has been suggested, and I believe this suggestion is sound, to add to this provision the following:

> "To the extent that such methods and standards require accounting, they shall be adapted, so far as practicable, to the accounting systems used by war contractors, if consistent with sound accounting practice."

The Director will be required to secure uniformity among Government agencies in the administration of termination settlements and interim financing. In addition, the bill provides that the Director shall make regulations for the speedy removal of termination inventories from war plants in order to clear them for other production. This removal is a vitally important phase of the contract termination program. Without quick clearance of plants, industry will be unable to resume promptly civilian production and furnish employment to returning service men and workers released from war production.

The bill establishes as the policy of the Government on account of termination of all types of war contracts, whether they be fixed price or cost-plus-fixed-fee contracts, or any other form, and to pay such fair compensation to all war contractors, whether they be prime contractors, first-tier subcontractors or lower-tier subcontractors. In order to insure fair compensation to all war contractors, S. 1718 authorizes the contracting agencies to amend *prime* contracts—and to approve or ratify the amendment of *sub*contracts by the parties thereto—in all cases where such contracts do not allow fair compensation. This provision is of particular importance to subcontractors because a survey made by the Smaller War Plants Corporation has shown that many subcontracts deprive subcontractors of fair compensation, leaving them in a less advantageous position than prime contractors. This situation is the result of the failure on the part of the contracting agencies to provide a uniform termination clause for subcontracts.

The Joint Contract Termination Board, under the Chairmanship of Mr. John Hancock, established in the Office of War Mobilization, has worked out a uniform termination clause for fixed price *prime* contracts. At the time of the promulgation of that clause, the Board indicated that it had under consideration a similar clause for subcontracts. So far, however, no such clause has been provided.

Fair compensation, as provided for in S. 1718, includes, but is not limited, to the following:

> (1) Reasonable costs incident to termination and settlement;
>
> (2) Reasonable costs of removing and storing termination inventories;
>
> (3) Such allowance for profit on the work done for the terminated part of the contract as is reasonable under the circumstances; and
>
> (4) Interest on the termination claim.

This provision leaves the door open

for the Director to use some or all of the principles of cost determination worked out by the Joint Contract Termination Board. I believe that it is entirely proper to deal in a general way with the various costs allowable in termination settlements, and thus leave the statutory provision flexible enough so as to allow the Director to implement the statute by appropriate regulations as he deems necessary from time to time.

The contracting agencies are authorized to settle termination claims or any part thereof, either by agreement with the contractor or by determination if no agreement has been reached. Any negotiated settlement so reached is final and conclusive, except for fraud and renegotiation for excessive profits. Where an agreement has not been reached, a determination made by a contracting agency is similarly final and conclusive unless appealed in accordance with the provisions of the bill.

In order to make sure that prime contractors and subcontractors have adequate working capital available while waiting for settlement of their termination claims, the bill establishes a policy of allowing all war contractors interim financing to the extent of 90 percentum of their termination claims. The Director is instructed to prescribe the types of estimates, certificates or other evidence which may be required by the contracting agencies in support of such interim financing.

Here again the bill attempts to keep the provision for interim financing as flexible as possible in order to allow the contracting agencies to use all possible methods of financing, such as partial payments, direct loans, or government guaranteed loans. In case a contractor secures excess interim financing, he is liable to the Government for a penalty of 12 percentum per annum on such excess.

This proposed legislation, I believe, will remove the danger of leaving terminated claims unsettled for an indefinite period of time, thus depriving war contractors of their working capital necessary for the prompt reconversion to civilian production and full employment so essential to our post war economy.

Now, let us look for a moment at the legislative situation with respect to contract termination bills in the Senate and in the House of Representatives. In addition to S. 1718, there is before the subcommittee, S. 1730, which was likewise introduced by Senator George and myself. S. 1730 was introduced for the purpose of carrying out the general program laid down by Senator George's Special Committee on Post War Economic Policy and Planning. Substantially all of the provisions contained in S. 1718 were incorporated into S. 1730. In addition, S. 1730 provides for the establishment of an Office of Demobilization and contains provisions for the disposal of surplus property.

As you may have seen in the press, Senator George's Committee met a short while ago and decided to recommend to the War Contracts Subcommittee to lay aside for the time being S. 1730 and to report as speedily as possible S. 1718 with certain amendments which Senator George's Committee has submitted. The War Contracts Subcommittee in the meantime has prepared amendments of its own, and I hope that it will be able to report S. 1718 as amended to the full Military Affairs Committee at an early date.

In the meantime, the House Military Affairs Committee has reported to the Floor of the House, H. R. 3022 which places control over all termination settlements in the hands of the Comptroller General. The House Naval Affairs Committee has been holding hearings on H. R. 4496, in-

troduced by Mr. Vinson, which deals with termination settlements by the Navy and which gives the Navy Department authority to make final settlements. Finally, the House Judiciary Committee has before it H. R. 4392, a companion bill to S. 1730, introduced by Mr. Kefauver.

The legislative picture looks very confused indeed. The Congress is concerned with two important problems which call for an early solution. The first problem is to resolve the conflict, as to whether the procurement agencies or the Comptroller General shall have the final say in connection with contract settlements. The second problem is, whether once the first problem has been resolved, contract settlements shall be dealt with by separate legislation or whether it shall be made part of over all mobilization and demobilization legislation. Let me address myself to the first problem.

I believe that the conflict between the procurement agencies and Messrs. Baruch and Hancock on the one hand and the Comptroller General on the other hand, does not bring to the fore the basic problem of the relationship between the contracting agencies, the Comptroller General and the Congress. The procurement agencies argue that contract settlements would be delayed indefinitely if the Comptroller General is authorized to audit and finally approve all settlements, and Messrs. Baruch and Hancock fear that the Comptroller General, under those circumstances, might

"quibble the Nation into a panic."

The Comptroller General, on the other hand, has argued that contract settlements cannot be entrusted to the procurement agencies because of their failings in connection with their administration of cost-plus-fixed-fee contracts which has often resulted in excessive costs to the Government.

From what little I have seen in connection with the Subcommittee's Investigation of the administration of cost-plus-fixed-fee contracts, I can readily believe that the procurement agencies have much reason for their desire to keep the Comptroller General out of many aspects of war procurement lest he discover a lot of dust under the carpets and in the dark corners of the parlor, left there by the careless housekeeping of the procurement agencies.

On the other hand, it is hard for me to follow those who support the idea of placing the Comptroller General in charge of termination settlements. It is my firm belief as expressed in S. 1718, that no matter what the shortcomings of the contracting agencies have been in taking care of the war procurement program, the job of making contract settlements must, nevertheless, be left to them under the guidance of policies laid down by the Congress and implemented by regulations of the Director of Contract Settlements. It is my judgment that under such a program the procurement agencies will improve the efficiency of their operations. Having made the contracts and being in possession of all the necessary facts, the contracting agencies are in a better position to wind up expeditiously the war procurement program.

In order to protect industry from the uncertainty of tentative settlements and enable it confidently to chart its future course, it is imperative that all settlements made by the contracting agencies shall be final in the absence of fraud. This does not mean, however, that the Comptroller General has no function in the contract termination picture. In fact, S. 1718 gives the Comptroller General the very important function of investigating settlements to establish whether such settlements were induced by fraud. Furthermore, there is no reason why the

function of the General Accounting Office should be as restricted as is proposed under S. 1718. While the Comptroller General should have the power to stop payments and to recover funds already paid only in case of fraud or illegal payments, I believe that the Comptroller General should be specifically directed to review termination settlements for the purpose of discovering negligent practices and waste of public funds and to report the results of his investigations to the Congress. I believe that this investigative function of the Comptroller General is one of the most vital functions of that office. If the Comptroller General's reports should reveal that S. 1718 does not adequately protect the Government, Congress could then take remedial action.

One of the purposes in passing the Budget and Accounting Act of 1921, was to create in the Comptroller General an agency on which the Congress could rely in bringing to the attention of the Congress all cases of mismanagement, waste or inefficiency in the handling of financial matters by administrative officers and of recommending action for the improvement of unsatisfactory conditions. These duties are set forth in Section 312 and 313 of the Act, which direct the Comptroller General to investigate all matters relating to the receipt, disbursement and application of public funds and to report to Congress at the beginning of each regular session, in writing, of the work of the General Accounting Office, making recommendations concerning legislation looking to greater economy and efficiency in public expenditures. All Governmental departments and agencies are instructed to furnish all necessary information to the Comptroller General.

That, as I see it, is the important and proper function of the Comptroller General in the picture of contract termination. This function of serving as an investigating arm of the Congress is infinitely more important and will save much larger sums than will the post audit by the Comptroller General of termination settlements.

This vital function of the Comptroller General must be supplemented by a companion program of the procurement agencies and the accounting profession to develop good accounting practices. The evidence gathered by the War Contracts Subcommittee in its recent study of the administration of cost-plus-fixed-fee contracts points toward grave deficiencies on the part of industry and the procurement agencies in accounting for and controlling the use of manpower and materials. Today in war production, this situation has brought about a shocking underutilization of our Nation's manpower and extravagant expenditures of our taxpayers' money. During the earlier stages of war production the primary emphasis was in the quick establishment of adequate production facilities and the development of mass production methods for the output of the necessary war material so urgently needed. There was little time then to establish efficient production and accounting controls. Better accounting practices and better housekeeping during the remaining period of war producton will greatly facilitate the handling of the termination problem during the post war era. Without such improved housekeeping on the part of industry and the procurement agencies, there may be a scandalous waste of Federal funds when terminated contracts are settled on a large scale.

The second problem, referred to earlier, is the problem of how termination legislation shall be handled in the Congress. Should there be a separate bill dealing with termination problems only or a general overall bill dealing with all mobilization and demobilization problems.

Two measures are pending before the War Contract Subcommittee which in one way or another would establish an overall mobilization and demobilization agency. One of the measures is S. 1730, which I have already referred to, and which in addition to providing for contract termination propose to establsh an Office of Demobilization and make provisions for the disposal of surplus property. The other measure, S. 1823, sponsored by Senator Kilgore is even more inclusive and would deal with the problems of cut-backs, surplus property disposal and training and placement of war workers and returning servicemen.

Whether all these problems are dealt with in a single measure or in several separate measures is largely a matter of legislative procedure. The important thing is that the Congress deal with all phases of mobilization and post war adjustment. A contract termination bill calls for a companion bill on war surplusses and the two bills in turn are unthinkable without companion legislation on retraining and reemployment. However, all along, the War Contracts Subcommittee has felt that the problem of taking care of war workers rendered unemployed on account of contract termination is one which must be dealt with in conjunction with termination settlements. Industry, likewise, has all along demanded a clarification of the issue whether dismissal wages may be included as an allowable cost in termination settlements.

Some time ago, the Subcommittee prepared a staff draft of a provision calling for the allowance of the payment of dismissal wages in contract settlements which was widely circulated and on which we have received many comments. These comments have convinced me that any provision for the payment of dismissal wages in connection with contract termination would be inadequate. There are formidable administrative difficulties in having Government funds placed in the hands of private individuals for distribution to discharged workers. Furthermore, the payment of such dismissal wages would discriminate against workers who are actually doing war work, but who are not doing so under Government contracts. Finally, the payment of such dismissal wages would not depend upon the incident of subsequent unemployment.

Once the thought of incorporating a provision for the payment of dismissal wages in S. 1718 is abandoned, the problem is, what should take its place. Some have suggested to tie the Wagner-Murray-Dingell Bill (S. 1161) which calls for a general extension of our social security system to the contract termination bill. Others have suggested that we take those parts of the Wagner-Murray-Dingell Bill dealing with unemployment compensation and add those parts to S. 1718. Others have proposed to leave the problem of providing for unemployed war workers to the future and not to delay passage of S. 1718.

Another alternative is suggested by the provisions of S. 1823 which would provide for Federal interim placement benefits to unemployed servicemen and civilian workers for a period of two years after termination of hostilities.

It is imperative that we find some adequate provision which will protect all those rendered unemployed during the period of reconversion. This important problem is now being studied and I believe that it can be solved without delaying in any way the prompt passage of S. 1718.

That is the legislative picture as far as terminaion legislation, and S. 1718 in particular, is concerned. I hope that the enactment of this legislation will provide the necessary statutory basis for the quick and

equitable settlement of termination claims. However, no matter how adequate this proposed legislation may be—no matter how effective its administration by the Director and the contracting agencies, the greatest contribution towards a speedy winding up of our war procurment program when "V" day arrives must be made by industry itself with the competent assistance of the members of your profession. Your profession and your clients must undergo a searching self-examination and only you and your clients can give the answer to the question "is industry prepared when 'V' day comes, to wind up the war procurement program expeditiously and to enter into the period of reconversion fully prepared so that the country's millions can be gainfully employed and the future of our democracy assured?"

In conclusion let me express my thanks and appreciation for this opportunity to discuss with you this important national problem. My committee will be glad to have the aid of your organization on all these problems of conversion.

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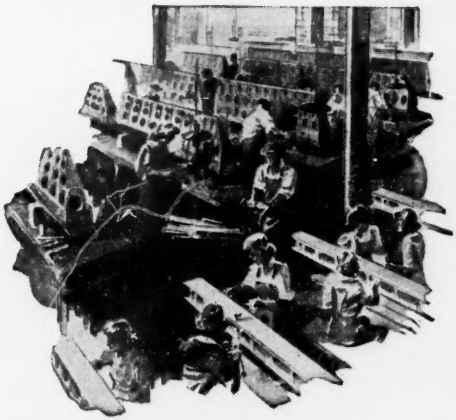

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